

The State as Facilitator

By Dr Roelof Botha (GOPA Group SA (Pty) Ltd)

According to most of the free world's respected social commentators, including Francis Fukayama, the end of the Cold War did not merely signal the passing of a particular period of history, but the end of history in terms of humankind's ideological revolution and the virtual universal acceptance of Western liberal democracy and free enterprise as the final forms of human government and the institutionalised economic environment, respectively.

Economics remains essentially a social science and it is hardly possible to claim the validity, in all circumstances, of scientific laws or universal truths. This is because economics is ultimately concerned about the study of certain behavioural patterns of human beings in the fairly ordinary business of life. It is not surprising that the claim of an advent of a universal *Pax Democratica* and market-driven economics in the aftermath of the collapse of the Soviet Union is not yet universally accepted.

In attempting to confirm whether the end of the Cold War may indeed ultimately herald a *Pax Democratica*, it is necessary to avoid a disjointed ideological debate and to identify as many objectively verifiable trends as possible. The following observations will guide such an effort, as they rely heavily on factual information:

- In 1989 the World experienced the start of a dramatic democratic revolution with the downfall of communist regimes throughout Eastern Europe. This brought to an end the Cold War that had existed for almost half a century between the West and the erstwhile Soviet Union and its allies.
- During the last quarter of the 20th Century, more than 50 countries shed authoritarian rule and reverted to some form of democracy. According to the United Nations Development programme, 150 of the world's 200 countries now hold multi-party elections. Of these, 85 are regarded as fully democratic, and these countries are home to almost 60% of the world's population. Furthermore, a free press or partly free press now exists in 130 countries, housing 65% of the world's population. Democracy initially seemed to have received a huge boost in the aftermath of decolonisation, but many of the post-colonial democracies failed as a result of, *inter alia*, widespread corruption and the absence of supply-side economic policies. Combined with the imposition of dictatorial rule in India in 1975, it seemed as if democracy was losing ground. Ever since the late 1970s, however, it became clear that the forces of democratic political freedom were reaching a historic groundswell. First were the transitions to democracy in Portugal and Spain. This was followed by the demise of the Soviet Union and the resurgence of democratic values has since been sweeping through Asia, Eastern Europe and Latin America, whilst starting to make ripples in Sub-Saharan Africa as well. It is widely regarded as an unstoppable force.

- One of the most damaging influences of the concept of central planning by an elitist and self-appointed dictatorial regime is its ideological self-discrediting. Plattner (1992) points out that Soviet leaders themselves attributed their system's failures to its lack of democratic markets and political democracy. By admitting that a handful of dictators cannot ever hope to follow policies that reflect the will of the majority of the people, the erstwhile Soviet leaders effectively conceded the ideological struggle to the West.
- The freedoms associated with the economic systems that are prevalent in virtually all democracies ensure that both individual and collective initiative and achievement are rewarded, whilst inefficiency is punished. Resources are, by and large, allocated on the grounds of the maximisation of utility and productivity. The result is a highly versatile, innovative and efficient economy. In sharp contrast, Marxist-Leninist socialism has proven in practice to rely heavily on the prescriptions of an incompetent and clumsy bureaucracy. The plethora of regulations and restrictions on both the propriety and mobility of the factors of production stifle initiative and inevitably erode productivity. Furthermore, the concentration of ultimate political and economic power in the hands of a few unelected members of the ruling class is certainly more fearful than any political excesses encountered in a democratic system.
- One of the most serious technical flaws of a totalitarian regime is its inability to adjust to new ideas, new technologies and the spread of knowledge. This is, firstly, by design, as comprehensive censorship has always been a feature of dictatorial regimes and, secondly, due to the rigidity of decision-making that had become a feature of communist societies. Shortly before the collapse of communism, there were 50,000 personal computers in the Soviet Union, compared to 30 million in the United States.
- Viewed from an historical perspective, liberal democracy is the outgrowth since the 17th century of the concerted efforts by social and political philosophers to free humanity from the shackles of dictatorial state power and the religious dogmas that were imposed by a powerful church movement. The term "liberal" is not used in this context as representing any particular doctrine on the state's role in the economy or as the opposite to the generic meaning of "conservative". It simply implies that the state is not above the law, nor above the will of society.
- Liberal democracy has been credited for the abolition of slavery of any kind, or torture for any reason, or the unequal treatment of women and minority ethnic groups.
- Finally, it is worth noting that the utter destruction of liberal democracy was the focal point of attention of fascism and similar oppressive ideologies.

When viewed against the rise of free-enterprise democracies around the globe and the ending of more than 40 years of covert conflict between the erstwhile Communist world and the West, Fukayama's theory is certainly not as radical in 2008 than it was fifteen years earlier.

The early conclusion that a *Pax Democratica* may, in fact be in the process of cementing itself as a universal characteristic of the post-industrial world has been supported by a generally robust international economic performance. Signs are also appearing that confirm the spread of the benefits of the democratic free enterprise system to poorer countries. Since 1980, which marks the beginning of the so-called "new supply-side" era, private consumption per capita has grown by more than 2% per annum for the world as a whole, and by more than 4% per annum for the middle-income countries. Over the same period, the mortality rate for children has dropped by 45% and the world has experienced consistent improvements in most indicators of the quality of life as well as aggregate output.

Key elements of the new economy

The new era of supply-side economic policy attempts to minimise government involvement in the economy, and its early success has been unparalleled in terms of stable growth combined with price stability in most high income and middle-income countries. Emphasis is once again placed on supply-side economic analysis and the crucial role of productivity. The new supply-side era is, in fact, less of an exercise that revisits Say's Law (supply creates its own demand) than a second age of innovation ("working smarter", not "working harder").

The economic malaise that characterised many industrialised countries during the latter half of the 1970s proved to have been the result, *inter alia*, of high marginal tax rates; minimum wage legislation; extensive welfare policies; and excessive government interference in the economy in general. Economists now realise that it was wrong to focus exclusively on demand and to ignore the factors that increase the supply of output – capital accumulation; technical progress; improvements in the quality of the labour force; freedom from regulatory interference; and increases in personal incentives.

Much of today's supply-side economics is merely a return to basic ideas about creating capacity and removing government impediments to individual initiative that were central in the writings of the classical economists of the nineteenth century.

Supply-side economics is therefore not a new concept, but in essence involves a reformulation of the maxim that "to govern well one must govern little". The theory of the limitations of the state has, of course, been at the centre of public debate since time immemorial. The famous injunction to interfering governments, "stand out of my sunshine", has been attributed to Diogenes, who lived *circa* 350 B.C.

On the micro-economic side, emphasis switched from direct control through incomes policies to increased output and employment through deregulation, tax reductions, trade union control, privatisation and the abolition of wide-ranging price controls. Although the centrepiece of supply-side economics remains changes to marginal tax rates to strengthen

incentives for work, saving, investment and risk taking, its relevance in highly regulated economies is also clear.

Redefining the role of the state

A common characteristic of OECD countries and developing countries during the period 1960 to 1980 was the enormous growth in state involvement in the economy. For OECD countries, total government expenditure as percentage of GDP increased from below 20% to more than 40% over this period, on average, whilst the central government expenditure/GDP ratio for developing countries increased from approximately 10% to just below 30%.

The world economy performed poorly during the 1970s, and countries were increasingly being characterised by large fiscal deficits, bloated bureaucracies, high tax rates, low or negative GDP growth, high unemployment and high inflation. In many countries, particularly the high-income economies, it had become clear that the size of government and the extent of its regulatory role in the economy had become inversely correlated with real *per capita* income growth.

Much of the research that has followed the quest for redefining the role of the state in a modern free-enterprise economy has concentrated on reducing the role of government in the economy. In cases where rigid regulations inhibit private initiative and monopolistic state enterprises function in a sub-optimal way, the first step toward increasing the effectiveness of the state is certainly to reduce its involvement. Countries like China and Poland provide ample evidence of the economic benefits that can accrue by reducing the reach of the state.

Research has shown that the lowering of the level of government involvement in the economy can yield large dividends in highly regulated economies, particularly through the following:

- Freeing up of public resources, e.g. through diverting subsidies away from loss-making state enterprises toward basic education or economic infrastructure.
- Privatisation had positive effects in eleven out of twelve country case studies conducted in Europe, South America and Asia, particularly in the forms of increased productivity and investment as well as more efficient pricing of services.
- The removal of excessive regulations unlocks opportunities for private sector development, which also leads to more flexible market structures and lower transaction costs.

Arguably the most significant element of reform has been in the area of taxation. Personal income tax systems were severely criticised during the 1970s for discouraging the work effort and for being unfair with regard to horizontal equity. Flattening tax rate structures has been a major objective of tax reform in many countries. In the United Kingdom, the maximum tax rate on personal income was reduced from 83% in 1979 to 40% in 1989. In

the United States it was lowered from 70% in 1981 to 33% in 1988 and in Japan it was lowered from 88% in 1985 to 65% in 1990.

Tax rate reductions were mostly accompanied by the elimination of many tax preferences and provisions. The advantages of the reforms to personal income tax structures have included the reduction of evasion, the encouragement of labour force participation and the removal of economic distortions. Most importantly, however, has been the return to high and sustained growth in output through the incentive effect of lower taxes, which has automatically tended to lower the degree of government involvement in the economy (as measured by government expenditure/GDP ratios).

The table illustrates the range of reforms that have been implemented in many countries in recent years.

Post-1980 reforms to state intervention in the economy

- Deregulation of outmoded and unnecessary impediments to private sector activity.
- Privatisation of state assets (in part or in full) that are not part of core public sector activity.
- Tax reform aimed at efficiency and enhancing productivity through greater labour force participation.
- Outward-looking industrial development strategies aimed at the eventual removal of barriers to trade.
- Maintaining a strong and independent judiciary to resolve disputes and clarify ambiguities in laws and regulations.
- Separation of judicial, legislative and executive powers at the horizontal and vertical levels to ensure that veto points exist and that the public has faith in the stability of rules and regulations
- Public/private sector partnerships in the provision of services, particularly at local government level and in cases where public sector capacity building is required.
- Reducing corruption through the removal of unnecessary points of discretionary bureaucratic authority.
- Establishment of mechanisms for monitoring honesty and effectiveness amongst public sector decision-makers, e.g. through an official ombudsman or anti-corruption commission.
- Establishment of performance-based agencies within the core public sector (where feasible).
- Financial and management controls that ensure transparency and cost-effectiveness in the use of taxpayers' funds.
- Enhancing loyalty, motivation and competence in the public sector through merit-based recruitment and promotion, adequate compensation, and the building of *esprit de corps*.